INVESTMENT IMPLICATIONS

OF

NEW FEDERAL RETIREMENT PLAN

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First, let me introduce myself. I am Jon Fossel, Senior Vice President of Alliance Capital Management, one of the world's largest investment management organizations. At Alliance, we manage nearly $20 billion of other people's money, the vast majority of which, some $16 billion is for corporate pension plans and for state and local government retirement systems. Our clients include 25 of Fortune Magazine's top 100 companies, ranging from American Can to Union Carbide and 50 government retirement systems from the California Public Employee Retirement System to the State of New York, and here in Washington, the District of Columbia Teachers, Police and Firefighters and Judges Retirement Board. Our list of clients and the assets they entrust to our management have grown substantially over the years, in large part because our long term investment results have consistently met or exceeded our clients expectations. For example, during the past ten years, our equity accounts achieved a compound annual return of 13.4%, and our balanced accounts 12.1%. These results compare very favorably with the CPI which increased 8.2% per year during the same period, U. S. Treasury Bills which returned 8.6% annually, and the large majority of competing investment management organizations.

As regards myself, my 20 year investment career pretty much covers the waterfront from a security analyst at TIAA-CREF, to Chief Investment Officer at American General Insurance Company's mutual fund subsidiary. From managing pension portfolios such as the United Nations and the State of Kansas at Citibank to my present position at Alliance Capital.

IN ADDITION TO MY INVESTMENT CAREER, I ALSO SPENT TWO TERMS IN THE NEW YORK STATE ASSEMBLY WHERE I SERVED ON THE WAYS & MEANS COMMITTEE AND THE GOVERNMENT OPERATIONS COMMITTEE, TWO YEARS AS ITS RANKING MEMBER. EVEN THOUGH MY POLITICAL CAREER WAS CUT SHORT IN 1982 WHEN I RAN UNSUCCESSFULLY FOR CONGRESS IN NEW YORK'S 20TH CONGRESSIONAL DISTRICT, MY INTIMATE INVOLVEMENT WITH FISCAL, BUDGET AND RETIREMENT ISSUES IN THE STATE LEGISLATURE HAS GIVEN ME A FAR DEEPER UNDERSTANDING OF THE COMPLEXITY OF THE RETIREMENT ISSUES FACING CONGRESS TODAY.

MY ASSIGNMENT FOR THE REMAINING 15 MINUTES OR SO IS TO SHARE WITH YOU MY THOUGHTS ON THE INVESTMENT IMPLICATIONS OF CERTAIN PROPOSED CHANGES IN THE FEDERAL RETIREMENT SYSTEM REQUIRED BY THE SOCIAL SECURITY ACT AMENDMENTS OF 1983. I SHOULD POINT OUT THAT MY VIEWS DO NOT NECESSARILY REPRESENT THE VIEWS OF MY FIRM, BUT THEY DO PROBABLY REFLECT A BROAD CONSENSUS OF INVESTMENT THINKING TODAY.

LET ME SAY AT THE OUTSET THAT I INTEND TO FOCUS MY COMMENTS ON SENATOR STEVEN'S PROPOSED CIVIL SERVICE PENSION REFORM ACT - NOT BECAUSE I NECESSARILY AGREE OR DISAGREE WITH ITS MAJOR ELEMENTS, BUT RATHER BECAUSE IT IS AN EXCELLENT ATTEMPT TO CRYSTALIZE THE MAJOR ALTERNATIVES AND THEIR IMPLICATIONS.

INTRODUCTION

THE NEED FOR CONGRESS TO ADDRESS ITSELF TO ALTERNATIVES TO THE CURRENT CIVIL SERVICE RETIREMENT SYSTEMS IS ABUNDANTLY CLEAR TO NEARLY EVERY INTERESTED PARTY. THE ACTIONS TAKEN BY CONGRESS PRIOR TO JANUARY 1ST 1986 COULD HAVE A VERY MAJOR IMPACT ON:

- CURRENT AND FUTURE PARTICIPANTS.
- CURRENT AND FUTURE BENEFICIARIES.
- THE ATTRACTIVENESS OF FEDERAL EMPLOYMENT FOR EXISTING AND NEW WORKERS.
- THE FEDERAL BUDGET AND TAXES.
- THE U. S. FINANCIAL MARKETS.
- GROWTH IN THE U. S. ECONOMY.

IN OTHER WORDS, SENATOR STEVEN'S PROPOSAL, OR WHATEVER ALTERNATIVE IS ADOPTED, WILL HAVE A VERY BROAD AND LONG-LASTING EFFECT ON EACH AND EVERY AMERICAN, NOT ONLY FOR TODAY, BUT FOR GENERATIONS TO COME.

INTERESTINGLY, UNLIKE SO MANY GOVERNMENT INITIATIVES, THE CIVIL SERVICE PENSION REFORM ACT HAS THE POTENTIAL TO POSITIVELY IMPACT EVERY INTERESTED PARTY WITHOUT A CONCOMITANT OFFSETTING NEGATIVE FOR ANYONE. IN OTHER WORDS, IF DONE RIGHT, THERE ARE NO LOSERS - ONLY WINNERS.

I WOULD LIKE TO LOOK AT THE INVESTMENT IMPLICATIONS FROM TWO QUITE DIFFERENT PERSPECTIVES. FIRST, WHAT ARE THE IMPLICATIONS OF EACH OF THE PROPOSED ACT'S MAJOR ELEMENTS.

AMONG THESE ARE:

- PRIVATE SECTOR INVESTMENTS, AND I WOULD ADD, EXPANDED PUBLIC SECTOR INVESTMENTS VS. THE PRESENT SOLE USE OF SPECIAL TREASURY ISSUES.

- DEFINED CONTRIBUTION AND THRIFT PLAN VS. THE CURRENT DEFINED BENEFIT PLAN.

- STRUCTURAL ISSUES SUCH AS THE ROLE OF THE PENSION BOARD OF TRUSTEES.

- POLITICAL AND POLICY ISSUES SUCH AS INVESTING FOR "SOCIAL" PURPOSES.

SECONDLY, I WOULD LIKE TO EXAMINE THE INVESTMENT IMPLICATIONS OF THE PROPOSED ACT IN TERMS OF ITS EFFECT ON THE MAJOR INTERESTED PARTIES.

AMONG THESE ARE:

- THE FEDERAL EMPLOYEE, ESPECIALLY THE NEW EMPLOYEE.

- THE FEDERAL GOVERNMENT AS THE EMPLOYER.

- THE ECONOMY AND THE FINANCIAL MARKETS.

PRIVATE SECTOR INVESTMENTS

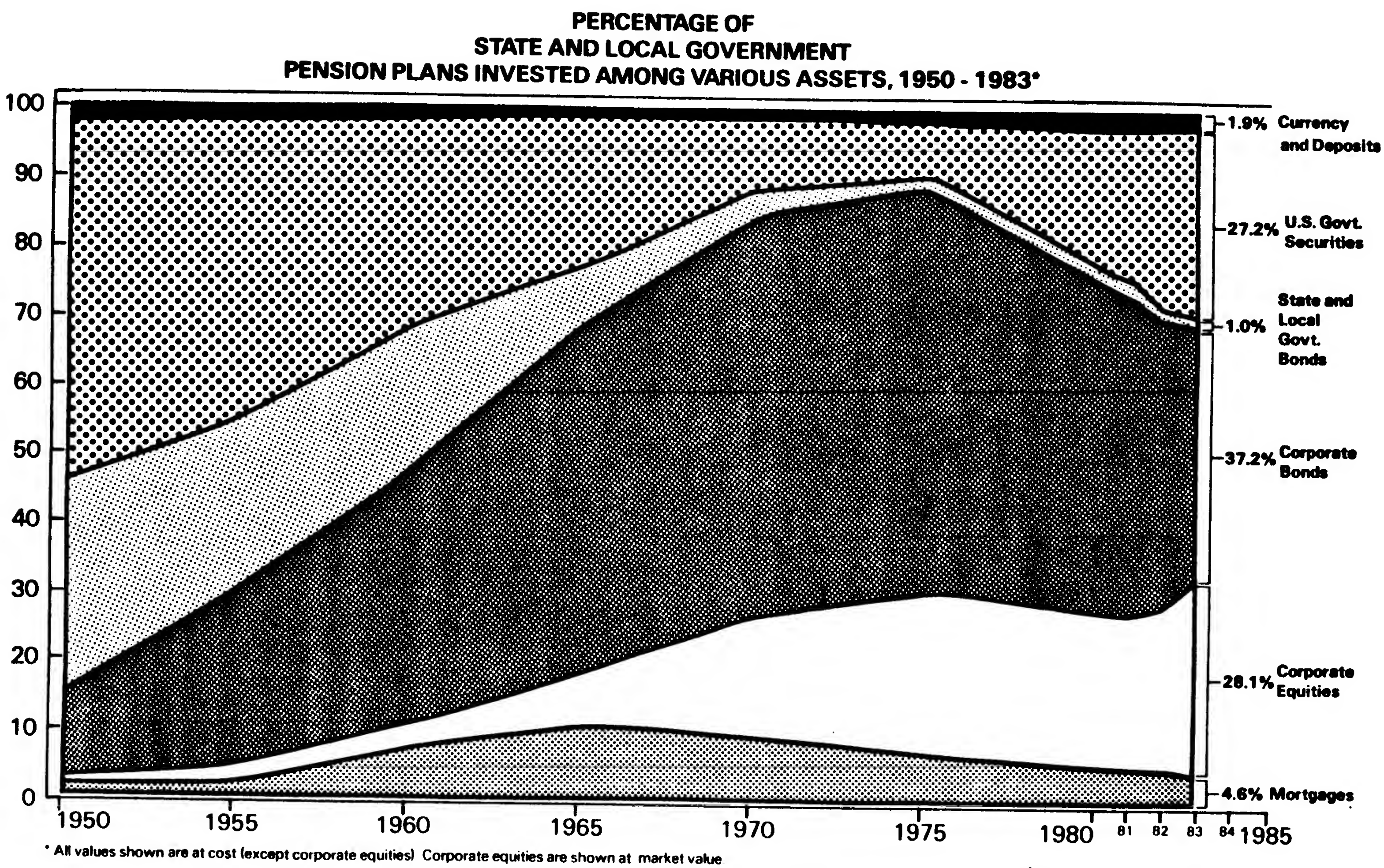
LET ME GO BACK NOW TO THE MAJOR ELEMENTS OF THE ACT AND EXAMINE THE INVESTMENT IMPLICATIONS OF UTILIZING PRIVATE SECTOR INVESTMENTS INSTEAD OF THE CURRENT PRACTICE OF BUYING AND HOLDING SPECIAL TREASURY SECURITIES.

FIRST, LET ME SAY THAT PRIVATE VS. PUBLIC INVESTMENTS IS NOT THE RIGHT ISSUE. THE RIGHT ISSUE IS: "WHAT INVESTMENT POLICY IS BEST SUITED TO PROVIDING APPROPRIATE RETIREMENT BENEFITS TO FEDERAL RETIREES AT THE LEAST COST TO THE EMPLOYER AND CURRENT PARTICIPANTS, AT AN ACCEPTABLE LEVEL OF RISK".

IN MY OPINION, THE ANSWER TO THAT QUESTION IS THAT MOST INVESTMENTS INCLUDING: SPECIAL ISSUES, PUBLICLY TRADED TREASURY ISSUES, OTHER FEDERAL AGENCY ISSUES, CORPORATE BONDS, COMMON STOCKS, REAL ESTATE, VENTURE CAPITAL AND PROBABLY OTHER ALTERNATIVES, ARE APPROPRIATE HOLDINGS FOR A RETIREMENT SYSTEM AS LARGE AND WITH AS LONG-TERM A PERSPECTIVE AS THE FEDERAL GOVERNMENT'S. THE PROPER MIX OF THE VARIOUS INVESTMENTS WILL DEPEND ON THE CHANGING MIX OF THE WORKFORCE, ACTUARIAL ASSUMPTIONS, THE NATURE OF THE PLAN OR PLANS, THE PREFERENCE (IF THEY HAVE A CHOICE) OF THE EMPLOYEES, CHANGING ECONOMIC AND INVESTMENT TRENDS, AND THE PROSPECTIVE REAL RETURNS AND RISK ASSOCIATED WITH EACH ALTERNATIVE.

THE FOLLOWING CHART (EXHIBIT I) SHOWS HOW THE INVESTMENT MIX OF AMERICA'S STATE AND LOCAL GOVERNMENT PENSION PLANS HAVE CHANGED OVER THE PAST 33 YEARS. SOME OF THE CHANGE IS SECULAR IN NATURE SUCH AS THE DECLINE IN STATE AND LOCAL GOVERNMENT BONDS BUT THE MAJORITY IS UNDOUBTEDLY IN RESPONSE TO CHANGING MARKET AND INVESTMENT RETURN CONDITIONS.

EXHIBIT I



* All values shown are at cost (except corporate equities) Corporate equities are shown at market value

Source: Federal Reserve Board Flow of Funds Accounts.

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A SIMILAR CHART FOR CORPORATE PENSION PLANS WOULD SHOW A VERY DIFFERENT ASSET MIX BUT SIMILAR LONG-TERM TRENDS. AS THE COST OF PROVIDING APPROPRIATE RETIREMENT BENEFITS HAS ESCALATED, PLAN SPONSORS AND THEIR INVESTMENT MANAGERS HAVE BECOME MORE SENSITIVE TO ENHANCING RETURNS WHILE AT THE SAME TIME MAINTAINING RISK AT ACCEPTABLE LEVELS. I SAY ACCEPTABLE LEVELS INSTEAD OF SAYING "MINIMIZING RISK" BECAUSE BY DEFINITION A RETIREMENT SYSTEM HAS A LONG-TERM INVESTMENT PERSPECTIVE. EMPLOYEES AND/OR EMPLOYERS MAKE CONTRIBUTIONS OVER A VERY LONG NUMBER OF YEARS AND BENEFICIARIES USUALLY RECEIVE BENEFITS FOR MANY YEARS. THEREFORE, IN ORDER TO IMPROVE BENEFITS AND/OR REDUCE COSTS THROUGH ATTAINMENT OF HIGHER RETURNS THE ASSUMPTION OF SOME SHORTER TERM VOLATILITY (OR RISK) IS PERFECTLY APPROPRIATE (AND PRUDENT).

THE FOLLOWING TABLE (EXHIBIT II) ILLUSTRATES THE COMPOUND ANNUAL RETURN ACHIEVED FROM THE FOUR MAJOR CLASSES OF INVESTMENT ASSETS OVER THE PAST 57 YEARS.

EXHIBIT II

STOCKS, BONDS, RISK FREE ASSETS, & INFLATION
COMPOUND GROWTH RATES, 1926-1983

	NOMINAL	REAL
COMMON STOCKS (S&P 500)	9.6%	6.6%
LONG-TERM CORPORATE BONDS	4.2%	1.2%
LONG-TERM GOVERNMENT BONDS	3.5%	0.5%
TREASURY BILLS	3.2%	0.2%
INFLATION	3.0%	—

Source: University of Chicago

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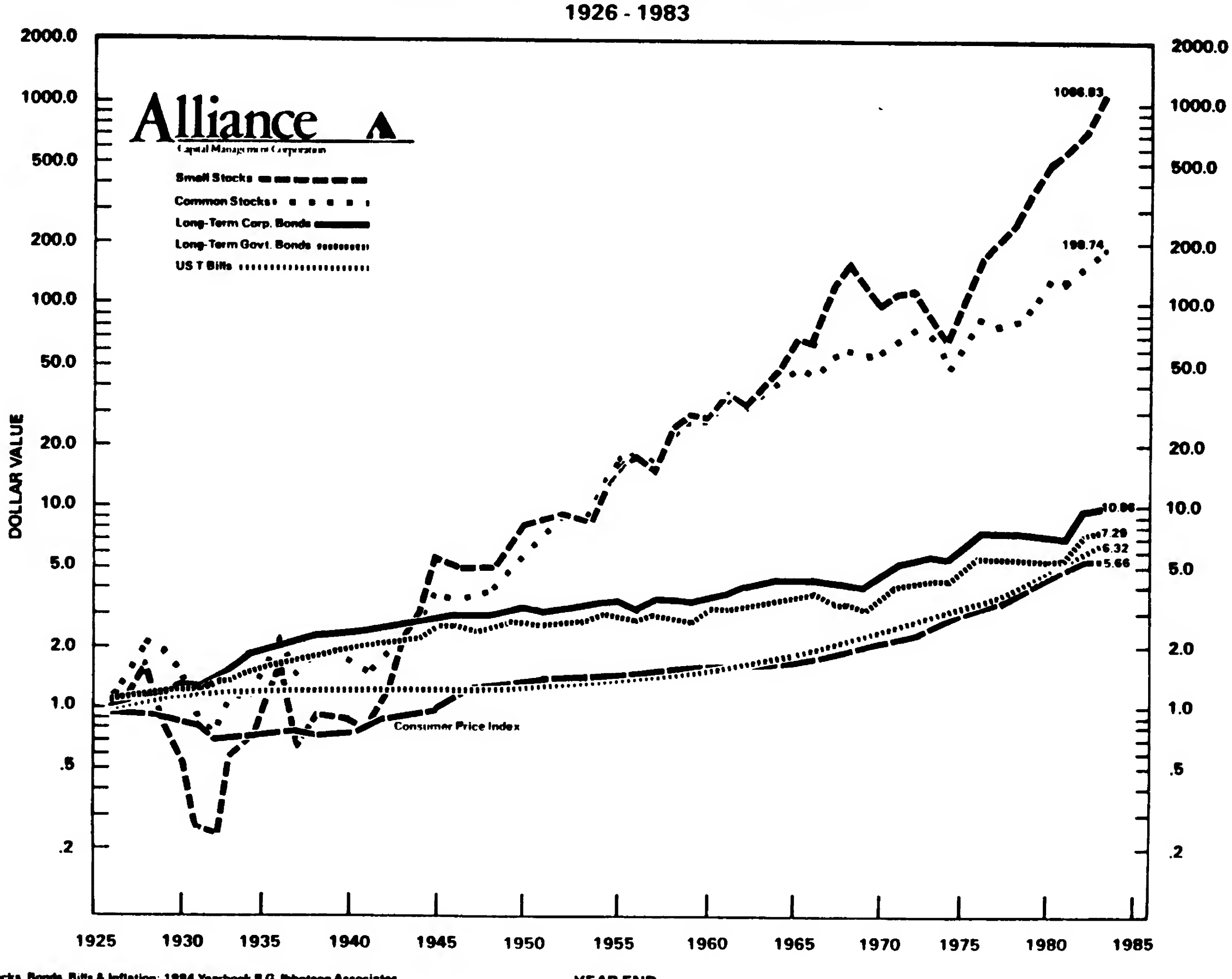
THE RISKIEST (OR MOST VOLATILE) ASSET, COMMON STOCKS, ACHIEVED THE HIGHEST RETURN BY THREE TIMES AS MUCH PER YEAR AS U. S. TREASURY BILLS, AN OSTENSIBLY RISK-FREE INVESTMENT, WHICH IS ALSO A VIRTUALLY RETURN-FREE INVESTMENT, IN REAL TERMS.

THE NEXT CHART (EXHIBIT III) SHOWS DRAMATICALLY THE LONG TERM IMPACT OF COMPOUNDING A GIVEN DOLLAR OF INVESTMENT AT A HIGH RATE.

EXHIBIT III

WEALTH INDICES OF
INVESTMENTS IN THE U.S. CAPITAL MARKETS
1926 - 1983



Source: Stocks, Bonds, Bills & Inflation: 1984 Yearbook R G Ibbotson Associates, Chicago, 1984

THE CHART SHOWS THAT ONE DOLLAR INVESTED IN COMMON STOCKS AT THE END OF 1925 WOULD HAVE BEEN WORTH NEARLY $200 BY THE END OF 1983 WHEREAS THAT SAME DOLLAR INVESTED IN LONG TERM CORPORATE BONDS WOULD BE WORTH $11, SEVEN DOLLARS IF IN LONG TERM GOVERNMENT BONDS, SIX DOLLARS IF IN TREASURY BILLS. OBVIOUSLY, THE IMPACT OF HIGHER RETURNS HAS SIGNIFICANT POSITIVE IMPLICATIONS FOR EMPLOYEE AND EMPLOYER ALIKE.

THE GRAPH, HOWEVER, SHOWS SOMETHING ELSE AS WELL, AND THAT IS HOW MUCH MORE VOLATILE THE SHORTER TERM RETURN FROM STOCKS HAS BEEN WHEN COMPARED TO LESS RISKY INVESTMENT ALTERNATIVES. OVER THIS PERIOD, THE ANNUAL RETURN FOR STOCKS RANGED FROM +54% IN 1933 TO -43% IN 1931. WHEREAS LONG TERM GOVERNMENT BOND RETURNS RANGED FROM +30% IN 1932 TO -16% IN 1946.

ALL CLASSES OF ASSETS EXCEPT SHORT-TERM TREASURY BILLS HAD AT LEAST ONE TEN YEAR PERIOD WHEN <u>BOTH</u> NOMINAL AND REAL RETURNS WERE NEGATIVE. HOWEVER, A DIFFERENT PICTURE EMERGES WHEN TWENTY YEAR HOLDING PERIODS ARE EXAMINED. AS THE FOLLOWING TABLE (EXHIBIT IV) SHOWS, EVERY CLASS OF ASSET HAD A POSITIVE NOMINAL RETURN FOR ANY TWENTY YEAR PERIOD.

EXHIBIT IV

COMPOUND ANNUAL RATES OF RETURN OVER BEST/WORST 20 YEAR PERIODS (1926-1983)

	Best 20 Years		Worst 20 Years	
	Nominal	Real	Nominal	Real
Small Stocks	21.1% (1942-61)	17.2% (1942-61)	5.7% (1929-48)	4.0% (1929-48)
Common Stocks	16.9% (1942-61)	13.0% (1942-61)	3.1% (1929-48)	0.8% (1962-81)
Long Term Corporate Bonds	5.5% (1926-45)	5.4% (1926-45)	1.3% (1950-69)	-2.7% (1962-81)
Long Term Government Bonds	4.7% (1926-45)	4.6% (1926-45)	0.7% (1950-69)	-3.1% (1962-81)
Treasury Bills	6.1% (1962-81)	1.0% (1952-71)	0.4% (1931-50)	-3.1% (1933-52)
Inflation	5.9% (1962-81)		0.1% (1926-45)	

SOURCE: ***Stocks, Bonds, Bills and Inflation: 1984 Yearbook,*** **R.G. Ibbotson Associates, Chicago, 1984.**

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THIS TABLE IS DRAMATIC EVIDENCE OF THE HIGHER LONG-TERM RETURNS THAT IS LIKELY TO BE FOUND IN MORE RISKY (THAT IS MORE VOLATILE ASSETS) AND ALSO SHOWS THAT OVER LONGER TIME PERIODS THE RISK OF NEGATIVE RETURNS FROM COMMON STOCKS, THE MOST VOLATILE ASSETS, HAS BEEN WELL WITHIN ACCEPTABLE AND PRUDENT LIMITS.

WHILE THE PRECEDING ANALYSIS IS HISTORICAL, IT MIGHT BE INSTRUCTIVE TO TAKE A LOOK INTO THE FUTURE THROUGH THE EYES OF 126 OF THE COUNTRY'S LARGEST STATE AND LOCAL GOVERNMENT PENSION FUND OFFICIALS.

THE TABLE (EXHIBIT V) SHOWS THAT FOR THE NEXT 5-10 YEARS, THESE FUNDS EXPECT THE HISTORICAL RELATIONSHIP BETWEEN RISK AND RETURN TO BE MAINTAINED, WITH THE MORE VOLATILE INVESTMENTS, EMERGING GROWTH STOCKS, TO OFFER FAR HIGHER RETURNS THAN LOW RISK INVESTMENTS SUCH AS TREASURY BILLS. I MIGHT ADD A PERSONAL OPINION HERE, WHICH IS THAT I BELIEVE THE TOTAL RETURN REALIZED BY LONG-TERM HIGH YIELDING, HIGH QUALITY BONDS WILL EXCEED RETURNS FROM COMMON STOCKS OVER THE NEXT SEVERAL YEARS ON A RISK ADJUSTED BASIS. THAT IS TO SAY, AS AN ACTIVE MANAGER OR A BOARD MEMBER OF THE NEW CIVIL SERVICE RETIREMENT SYSTEM, I WOULD HAVE A VERY LARGE PORTION OF THE FUND INVESTED IN BONDS TODAY.

EXHIBIT V

RATE OF RETURN EXPECTATIONS BY STATE AND LOCAL PENSION FUND OFFICIALS

Base: 126

	90-Day Treasury Bills	S&P 500 Stock Average	Established Growth Stocks	Emerging Growth Stocks	Buy-and-Hold Corporate Bonds	Actively Managed Corporate Bonds	Equity Real Estate	Real Estate Mortgages
Mean	8.9%	12.5%	14.3%	15.9%	10.0%	11.4%	12.0%	10.7%
Median	8.8%	11.5%	13.5%	15.5%	9.8%	11.5%	10.5%	11.5%

Source: Greenwich Research Associates, *Public Pension Funds 1984 Market Dynamics Report.*

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THE SIGNIFICANCE OF THE HISTORICAL AND PROSPECTIVE RETURNS REALIZED BY VARIOUS INVESTMENT ALTERNATIVES ARE THE FOLLOWING:

1. COMMON STOCKS AND CORPORATE BONDS HAVE IN THE PAST, AND MAY VERY LIKELY IN THE FUTURE, OFFER HIGHER LONG TERM RETURNS THAN TREASURY BILLS OR LONG-TERM GOVERNMENT BONDS.

2. THE SHORT-TERM VOLATILITY OF STOCKS IS SIGNIFICANTLY GREATER THAN BONDS OF ALL TYPES.

3. ALL INVESTMENT ALTERNATIVES HAVE ACHIEVED POSITIVE NOMINAL RETURNS OVER ANY TWENTY-YEAR PERIOD.

4. THE VAST MAJORITY OF TWENTY-YEAR PERIODS SHOWED POSITIVE NOMINAL AND REAL RETURNS FOR ALL INVESTMENT ALTERNATIVES.

SINCE, AS MENTIONED EARLIER, A LONG-TERM TIME HORIZON IS APPROPRIATE FOR THE FEDERAL RETIREMENT SYSTEM, IT IS MY STRONGLY HELD OPINION THAT A PROPERLY DIVERSIFIED INVESTMENT PORTFOLIO UTILIZING A FULL ARRAY OF PRUDENT INVESTMENT ALTERNATIVES WILL ACHIEVE MUCH HIGHER INVESTMENT RETURNS THAN THE APPROACH CURRENTLY FOLLOWED BY CSRS. ADDITIONALLY, THE HIGHER RETURN CAN AND SHOULD BE ATTAINED WITH MINIMAL INCREASE IN LONG-TERM VOLATILITY. THE ABOVE CONCLUSIONS ASSUME A PASSIVE INVESTMENT APPROACH, OBVIOUSLY ACTIVE MANAGEMENT OF SEGMENTS OF THE RETIREMENT SYSTEM'S ASSETS HAS THE POTENTIAL TO ENHANCE OVERALL RETURNS EVEN FURTHER.

AN ACTIVELY MANAGED INVESTMENT APPROACH UTILIZING ALL INVESTMENT ALTERNATIVES, FROM TREASURY BILLS AND BONDS, TO GOVERNMENT AGENCY AND CORPORATE BONDS, TO MORTGAGES AND REAL ESTATE TO COMMON STOCKS IS THE APPROACH THAT BEST ANSWERS THE QUESTION I POSED EARLIER WHICH WAS "WHAT INVESTMENT POLICY IS BEST SUITED TO PROVIDING APPROPRIATE RETIREMENT BENEFITS TO FEDERAL RETIREES AT THE LEAST COST TO THEIR EMPLOYER AND CURRENT PARTICIPANTS, AT AN ACCEPTABLE LEVEL OF RISK?"

THIS IS WHY MOST MAJOR CORPORATE AND PUBLIC SECTOR PENSION PLANS HAVE MOVED TO SUCH AN APPROACH OVER THE PAST TWENTY YEARS OR SO.

DEFINED CONTRIBUTION AND THRIFT PLAN

THE SECOND MAJOR ELEMENT OF THE PROPOSED ACT THAT HAS INVESTMENT IMPLICATIONS IS THE CREATION OF A DEFINED CONTRIBUTION PLAN IN COMBINATION WITH A THRIFT PLAN INSTEAD OF THE CURRENT CSRS DEFINED BENEFIT PLAN.

THE IMPORTANT INVESTMENT CONSIDERATION IS THE RECOGNITION THAT IN A DEFINED BENEFIT PLAN THE ASSETS OR LIABILITIES ARE, IN ESSENCE, OWNED BY THE EMPLOYER (OR IN THE CASE OF GOVERNMENT SYSTEMS, THE TAXPAYERS) WHO THEREFORE WILL REALIZE THE BENEFITS OF SUPERIOR INVESTMENT RETURNS AND ALSO BEARS THE COST OF INADEQUATE RESULTS AND/OR INSUFFICIENT CONTRIBUTIONS. IN DEFINED CONTRIBUTION AND THRIFT PLANS, ON THE OTHER HAND, THE EMPLOYEE OWNS THE ASSETS AND ASSUMES THE RISK AND REWARDS OF

THE INVESTMENT RETURNS REALIZED. THE MAJOR INVESTMENT IMPLICATION OF A MOVE TO DEFINED CONTRIBUTION IS THAT USUALLY EMPLOYEES ARE OFFERED A CHOICE OF INVESTMENT ALTERNATIVES AND MAY TAILOR THEIR INVESTMENT MIX TO SUIT THEIR PERSONAL FINANCIAL SITUATION AND RISK TOLERANCE. A YOUNGER EMPLOYEE, WITH HIGH POTENTIAL FOR CAREER ADVANCEMENT, MAY WISH TO HAVE A HIGHER PORTION OF HIS ASSETS INVESTED IN COMMON STOCKS OR REAL ESTATE, WHEREAS, ANOTHER EMPLOYEE WHO IS CLOSER TO RETIREMENT, MAY WISH TO HAVE HIS PLAN ASSETS INVESTED IN MORE CONSERVATIVE GOVERNMENT BONDS OR TREASURY BILLS. EITHER INDIVIDUAL COULD HAVE THE FREEDOM TO CHANGE THE MIX OF ASSETS IN HIS PLAN AS PERSONAL FINANCIAL SITUATIONS CHANGE.

SINCE THE EMPLOYEE AND RETIREE HAS THIS FLEXIBILITY, THERE WILL OBVIOUSLY BE A NEED TO PROVIDE A VARIETY OF INVESTMENT CHOICES. THEREFORE, THE SYSTEM MUST ACQUIRE, EITHER INTERNALLY OR EXTERNALLY, THE NECESSARY EXPERTISE TO MANAGE IN A PROFESSIONAL AND PRUDENT MANNER, AN APPROPRIATE RANGE OF INVESTMENT ALTERNATIVES.

ONCE THE MAJOR ISSUES OF INVESTMENT APPROACH AND PLAN STRUCTURE ARE RESOLVED, SOME OF THE TOUGHEST HURDLES STILL REMAIN. THESE ARE WHAT I WILL CALL THE STRUCTURAL, POLITICAL AND POLICY ISSUES.

STRUCTURAL ISSUES

TAKING THE STRUCTURAL ISSUES FIRST, IT IS CLEARLY IN THE BEST INTEREST OF ALL CONCERNED TO SET UP THE PENSION FUND'S BOARD OF TRUSTEES IN SUCH A WAY AS TO PROVIDE THE MOST PROFESSIONAL UNDERSTANDING OF PENSION AND INVESTMENT ISSUES. THERE IS AMPLE PRECEDENT FOR THE ESTABLISHMENT OF SUCH A BOARD TO BE FOUND IN MANY OF THE STATE SYSTEMS IN THIS COUNTRY AS WELL AS A NUMBER OF MULTI-NATIONAL EMPLOYERS SUCH AS THE UNITED NATIONS.

GENERALLY SPEAKING, THE BOARD SHOULD CONSIST OF EMPLOYEE, EMPLOYER AND POLITICAL REPRESENTATIVES AND ASSUMES BROAD POLICY-MAKING AND OVERSIGHT RESPONSIBILITIES INCLUDING:

- INVESTMENT POLICY.
- ASSET ALLOCATION.
- LEGAL AND CONTRACTURAL OVERSIGHT.
- HIRING THE EXECUTIVE DIRECTOR.

I PERSONALLY FEEL THAT, CONTRARY TO THE PROVISIONS OF THE PROPOSED ACT, THE EXECUTIVE DIRECTOR SHOULD BE HIRED BY THE BOARD AND THAT EMPLOYEES, BOTH CURRENT AND RETIRED, SHOULD HAVE BROADER REPRESENTATION ON THE BOARD. ONE OF THE MOST IMPORTANT STRUCTURAL ISSUES TO BE FACED IS WHETHER THE FUND'S ASSETS SHOULD BE MANAGED BY A PROFESSIONAL, INTERNAL STAFF OR BY EXTERNAL INVESTMENT MANAGERS. THERE ARE PRO'S AND CON'S IN EACH APPROACH AND AS YOU CAN SEE IN THE FOLLOWING TABLE (EXHIBIT VI) PUBLIC FUNDS IN THE U. S. USE BOTH INTERNAL AND EXTERNAL MANAGEMENT ON BOTH AN ADVISORY AND DISCRETIONARY BASIS. MANY MAJOR FUNDS CONTRACT OUT MANAGEMENT OF CERTAIN ASSETS ESPECIALLY THE MORE COMPLEX INVESTMENTS SUCH AS STOCKS AND REAL ESTATE, WHILE RETAINING INTERNAL MANAGEMENT FOR SHORT TERM INVESTMENTS AND PERMANENT LONG TERM INVESTMENTS.

EXHIBIT VI

HOW MANAGEMENT OF PUBLIC FUNDS VARIES WITH FUND CHARACTERISTICS

	Base	Internal Management	Advisory Management	Discretionary Management
Type of Fund				
State funds	(70)	70%	49%	46%
Municipal funds	(170)	42%	32%	66%
Large municipal	(36)	47%	56%	61%
Plan Assets				
Over $500 million	(68)	69%	50%	49%
Type of Management				
Internal	(32)	100%	0%	0%
Advisory	(26)	0%	100%	0%
Discretionary	(79)	0%	0%	100%
Number of Employees				
Over 20,000	(63)	65%	44%	52%

SOURCE: Greenwich Research Associates, *Public Pension Funds 1984 Market Dynamics Report.*

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EVEN THOUGH I HAVE A BIAS TOWARD PROFESSIONAL, EXTERNAL MANAGEMENT BECAUSE OF THE CRITICAL IMPORTANCE OF ATTRACTING AND RETAINING AN OUTSTANDING INVESTMENT STAFF, I BELIEVE THAT A FUND AS LARGE AS THE FEDERAL GOVERNMENT RETIREMENT SYSTEM COULD VERY WELL FIND IT COST EFFECTIVE TO PERFORM CERTAIN INVESTMENT FUNCTIONS ITSELF AND IN ANY EVENT SHOULD HAVE A HIGHLY COMPETENT INVESTMENT PROFESSIONAL AS EXECUTIVE DIRECTOR.

POLITICAL AND POLICY ISSUES

IN ORDER FOR THE FUND TO BE BEST ABLE TO ACHIEVE ITS LONG RANGE OBJECTIVES FOR ITS PARTICIPANTS, IT IS PARAMOUNT THAT THE EXECUTIVE DIRECTOR, THE PROFESSIONAL STAFF AND EXTERNAL MANAGERS BE AS FAR REMOVED FROM POLITICAL INFLUENCE AND INTERFERENCE AS POSSIBLE. THERE ARE TOO MANY EXAMPLES, EVEN IN THE VERY RECENT PAST WHERE BOARD MEMBERS OR OTHER OUTSIDE GROUPS INTRUDED INTO THE INVESTMENT PROCESS OF PUBLIC FUNDS WITH QUITE NEGATIVE RESULTS.

THIS IS NOT TO SAY THAT SUCH POLICY/POLITICAL ISSUES SUCH AS "SOCIAL INVESTING", I.E. HOUSING STIMULUS, URBAN REVITALIZATION, SOUTH AFRICA ETC. ARE NOT LEGITIMATE CONSIDERATIONS FOR THE BOARD. THEY ARE. HOWEVER, IT MUST BE RECOGNIZED THAT VIRTUALLY EVERY INVESTMENT POLICY DECISION HAS THE POTENTIAL TO IMPACT THE RETURN AND/OR RISK REALIZED ON THE FUND'S INVESTMENTS.

IN NO EVENT SHOULD THE BOARD MEMBERS OR ANYONE ELSE OTHER THAN THOSE SPECIFICALLY VESTED WITH THE PROPER AUTHORITY HAVE THE ABILITY TO MAKE INVESTMENT DECISIONS. THE PROPOSED ACT HAS ADDRESSED THIS ISSUE QUITE PROPERLY.

ANOTHER MAJOR POLICY CONCERN IS THE POSSIBILITY THAT THE FUND MIGHT CONTROL THE MARKET OR CERTAIN SECTORS OF THE MARKET.

IN MY OPINION, THESE FEARS ARE WHOLLY UNFOUNDED. IN THE FIRST PLACE, THE PROPOSED ACT PROVIDES FOR A VERY GRADUAL PHASE-IN OF THE PRIVATE SECTOR INVESTMENTS. SECONDLY, THE CURRENT AND PROSPECTIVE SIZE AND LIQUIDITY OF THE U. S. FINANCIAL MARKETS MAKE IT HIGHLY UNLIKELY THAT ANY RESPONSIBLY MANAGED FUND, EVEN ONE OF THIS SIZE COULD HAVE UNDUE INFLUENCE ON THE MARKET. THIRDLY, IT IS HIGHLY LIKELY THAT THE FUND'S ASSETS WILL BE WIDELY DIVERSIFIED AMONG GOVERNMENT AND CORPORATE BONDS, REAL ESTATE, MORTGAGES AND A LARGE NUMBER OF COMMON STOCKS, NOT CONCENTRATED IN ANY ONE SEGMENT.

IT IS HOWEVER LOGICAL TO CONCLUDE THAT ON A SUPPLY/DEMAND BASIS THE YIELD SPREAD BETWEEN TREASURY SECURITIES AND PRIVATE SECTOR SECURITIES COULD NARROW SLIGHTLY AS THE FEDERAL GOVERNMENT'S RETIREMENT SYSTEM INVESTED A GROWING SHARE OF ASSETS IN PRIVATE SECTOR INVESTMENTS. THE OVERALL LEVEL OF INTEREST RATES WOULD HOWEVER, CONTRARY TO THE CONCLUSION OF SOME OBSERVERS, REMAIN UNCHANGED.

ON THE SURFACE, IT APPEARS THAT THE MULTIPLICITY OF STRUCTURAL, POLITICAL AND POLICY ISSUES AFFECTING THE FUND'S INVESTMENT APPROACH ARE SO COMPLEX AND CONTROVERSIAL THAT IT WOULD BE EASY TO CONCLUDE THAT ITS JUST NOT WORTH UNDERTAKING MAJOR CHANGE. WE MUST REMEMBER, HOWEVER, THAT THERE IS A RESPONSIBILITY TO CURRENT AND FUTURE RETIREES THAT IS PARAMOUNT. MOST OF AMERICA'S MAJOR CORPORATIONS, OUR 50 STATES, MOST OTHER MAJOR POLITICAL SUBDIVISIONS AND OUR LARGEST LABOR UNIONS HAVE ALREADY CHOSEN A COURSE THAT UTILIZES MODERN INVESTMENT MANAGEMENT APPROACHES.

THEY HAVE DONE SO BECAUSE IT IS IN THE LONG-TERM BEST INTEREST OF THEIR CURRENT, FUTURE AND RETIRED EMPLOYEES.

THE PROPOSAL'S IMPACT

AS I STATED AT THE OUTSET, ANY NEW FEDERAL PENSION PLAN WILL HAVE A SIGNIFICANT IMPACT ON A BROAD CROSS SECTION OF AMERICA. THE ENTITIES MOST AFFECTED WILL BE FEDERAL WORKERS, THEIR EMPLOYER, AND THE NATION'S ECONOMY AND FINANCIAL MARKETS.

SENATOR STEVEN'S PROPOSED CIVIL SERVICE PENSION REFORM ACT HAS THE POTENTIAL TO YIELD A MAJOR POSITIVE BENEFIT ON ALL FRONTS.

THE FEDERAL EMPLOYEE

FOR THE EMPLOYEE IT PROVIDES THE OPPORTUNITY TO TAILOR HIS RETIREMENT PROGRAM TO HIS PARTICULAR NEEDS, AND TO ADJUST HIS INVESTMENT MIX OVER TIME TO REFLECT CHANGING PERSONAL FINANCIAL CIRCUMSTANCES. ADDITIONALLY, THE CONTRIBUTIONS TO EACH EMPLOYEE'S INDIVIDUAL ACCOUNT WILL BE OWNED BY THE EMPLOYEE, WILL BE PORTABLE IN THE EVENT THE EMPLOYEE CHANGES JOBS AND WILL THEREFORE BE INSULATED FROM POLITICAL OR BUDGETARY UNDERMINING.

WHILE IT IS TRUE THAT THE INVESTMENT RISK AS WELL AS THE REWARD OF THE INVESTMENT RESULTS ARE BORNE BY THE EMPLOYEE IN A DEFINED CONTRIBUTION PLAN, IT IS ALSO TRUE THAT SUCH A PLAN CAN PROVIDE A LOW RISK INVESTMENT ALTERNATIVE. FURTHERMORE, AS DISCUSSED EARLIER, IT IS HIGHLY LIKELY THAT THE LONG-TERM RETURNS FROM A PROFESSIONALLY MANAGED, WELL DIVERSIFIED FUND WILL EXCEED THE RETURNS FROM AN UNMANAGED FUND INVESTING ONLY IN SPECIAL TREASURY ISSUES. THIS IS NOT ONLY BECAUSE RETURNS FROM OTHER INVESTMENTS WILL, IN ALL LIKELIHOOD CONTINUE TO BE HIGHER OVER LONG TIME PERIODS, BUT EQUALLY IMPORTANT, BECAUSE ASSET MIX CAN BE ALTERED TO REFLECT ECONOMIC, MARKET, INFLATIONARY AND INTEREST EXPECTATIONS.

THE FEDERAL EMPLOYER

THE IMPACT ON THE FEDERAL GOVERNMENT IS LESS CLEAR BUT NONETHELESS, QUITE POSITIVE IN THE LONG RUN. IN THE FIRST PLACE, AS THE FUND'S ASSETS EARN HIGHER RETURNS THE COST OF PROVIDING THE SAME, OR EVEN HIGHER BENEFITS ARE REDUCED. ADDITIONALLY, THE PLAN WILL HAVE A KNOWN AND PREDICTABLE COST.

THE VERY SHORT-TERM BUDGET IMPACT MAY WELL BE SOMEWHAT NEGATIVE ALTHOUGH THE PRESUMPTION THAT BY BORROWING THE AMOUNT NECESSARY TO FUND THE NEW PLAN WOULD MERELY RAISE TREASURY YIELDS TO THE LEVELS PREVAILING ON PRIVATE INVESTMENTS IS TOTALLY UNSUPPORTABLE IN THE SHORT-TERM AND GIVES NO CONSIDERATION TO THE MULTIPLIER EFFECT ON THE ECONOMY AND TAX COLLECTIONS AS THE CONSEQUENCE OF ENHANCING CAPITAL FORMATION.

IN MY OPINION, THE NET RESULT FOR THE FEDERAL GOVERNMENT OVER THE LONG RUN WILL BE:

- LOWER COSTS
- BETTER BUDGETING
- HAPPIER EMPLOYEES
- HIGHER REVENUES

THAT'S AN UNBEATABLE COMBINATION!

THE ECONOMY & FINANCIAL MARKETS

THE IMPLICATIONS OF STEPS TAKEN TO STIMULATE CAPITAL FORMATION IN THE U. S. HAVE WELL-KNOWN LONG RANGE CONSEQUENCES THAT ARE GENERALLY POSITIVE. OBVIOUSLY, MOVING FROM AN UNDERFUNDED TO A FULLY FUNDED FEDERAL PENSION PLAN INVESTING IN THE PRIVATE SECTOR WOULD REQUIRE A LARGE AND GROWING FLOW OF FUNDS IMPACTING SAVINGS AND CAPITAL FORMATION. TO THE EXTENT THAT THESE DOLLARS EARN A HIGHER RETURN WHICH IS THEN REINVESTED, ARE MATCHED BY FURTHER INDIVIDUAL CONTRIBUTIONS FROM CURRENT CONSUMPTION, AND INCREASE FEDERAL TAX RECEIPTS BY STIMULATING ECONOMIC GROWTH, THEN THE FINANCIAL MARKETS AND THE ECONOMY WOULD BE BENEFITED.

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